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SUBJECT: IRELAND'S 2009 BUDGET: PUNTING THE PROBLEM DOWN THE ROAD

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Classified By: CDA Robert J. Faucher. Reasons 1.4 (b/d).

Summary

¶1. (C) Against the backdrop of a steadily worsening fiscal balance, the Irish government delivered its 2009 budget on October 14. In his budget speech Minister of Finance Brian Lenihan emphasized that this budget required shared sacrifice from all Irish citizens. The government expects a 6.5 percent government deficit through a combination of a slowing rate of spending growth and a tax increase of about Euro 2 billion. Current spending will rise by 6.5 percent, mostly as a result of spending increases on social welfare programs, education, and health care. Capital spending will fall slightly but is still high relative to other EU countries. The increase in taxes will come from a combination of increases in VAT and a special income levy expected to raise Euro 800 million, among other measures. Private sector commentators were disappointed with the modest cut in the deficit and some were critical of what they saw as overly optimistic economic growth assumptions. Thrust into the job amidst a collapsing economy, Lenihan's first budget was expected to be austere -- and it was. However, it made no mention of the potential need to bail out its ailing banks (Reftel). If it has to inject capital into the financial system, the budget will need to go back to the drawing board. Ireland's economic plight has added another distraction (on top of the failed Lisbon Treaty referendum) for the government to deal with, which may result in less focus on issues that matter to the U.S. End Summary.

Lenihan Delivers Austere Budget

¶2. (U) On October 14, Finance Minister Brian Lenihan delivered his 2009 budget speech to the Irish parliament. This was his first such speech as Minister and comes during Ireland's worst economic crisis in a generation. In it, he said that Ireland finds itself in "one of the most difficult and uncertain times in living memory" and called for shared sacrifice. He emphasized that the most vulnerable in society will be protected and took steps designed to assure the global business community that Ireland will remain a good place to do business. Lenihan forecasted that the government deficit will be 6.5 percent of GDP in 2009 (it stood at a surplus of 0.5 percent in 2007) and that current spending will rise by 6.5 percent in 2009, while tax revenue will rise by Euro 2 billion. He based these projections on the assumptions that GDP will fall by 0.8 percent in 2009 and that inflation will be 2.5 percent.

Key Revenue Measures

¶3. (U) The key revenue measures in the 2009 Irish Budget are as follows:

-- A one percent levy on income up to Euro 100,000 and two percent over Euro 100,000.
-- Value-added Tax (VAT) to increase from 20 to 21.5 percent.
-- Capital gains tax to increase from 20 to 22 percent.
-- The maximum rate of stamp duty on non-residential property reduced from nine to six percent.
-- Medical cards for people over 70 will be means tested and anyone not qualifying will receive a cash grant.
-- Automatic entitlement to child benefit to be reviewed.
-- Mortgage interest relief to be extended for first time buyers but reduced for non-first time buyers.
-- Sin taxes increased: 50 cents more for a pack of cigarettes and a bottle of wine.
-- Increases in motor vehicle taxes (by four to five percent depending on type of car) and gas tax (eight cents per liter).
-- Air travel tax of Euro 10 per passenger for journeys of over 300 kilometers.

Key Expenditure Measures

¶4. (U) The key expenditure measures in the 2009 Irish Budget are as follows:

-- The number of state agencies to be reduced by 41.
-- Euro 70 million cut in transport infrastructure expenditures.
-- Increased spending on social welfare (up 8.4 percent), education and science (up Euro 308 million), and health (up Euro 385 million).

-- Child benefit age limit reduced to 17 years of age from 18 beginning in 2010.
-- State pension to rise by Euro 7 per week.

The Government "Flunked"

¶5. (C) The main opposition party, Fine Gael, joined in the chorus of criticism of the government's budget plan. Andrew McDowell, economic advisor to the party, told Econoff that the government "flunked the challenge of reducing borrowing and day-to-day spending and instead focused on maintaining capital spending." He continued to say that the budget will make a bad situation worse and that the government missed an opportunity to engage in real public sector reform. Like others we spoke to, he believes that the government's forecasts for less borrowing in 2010 and 2011 are based on "unrealistic projections and assumptions." In October 14 comments, Richard Bruton, Fine Gael's finance spokesperson, said, "today's Euro 2.0 billion in tax hikes and another Euro 2.0 billion in cutbacks in vital infrastructure programs threaten to turn the current Irish recession into a sustained depression."

Economists Disappointed Too

¶6. (C) Local private-sector economists were disappointed with the government's budget-balancing effort. Econoff spoke to Jim Power, chief economist at Friends First, who described the budget as "savage." He felt that the bulk of the adjustment should have come from paring current spending rather than through tax increases. He worries that the income levy will exacerbate the downward pressure on disposable incomes, which will inhibit consumer spending and lead to a further contraction of the economy. Like other local economists, Power believes the growth forecasts the government is using are "overly optimistic" and that, under his assumptions, a 10 percent (vice 6.5 percent) deficit is

possible next year. He thinks the government may have to resort to a "mini-budget" early next year to revise spending and revenue plans if its assumptions turn out to be wrong.

¶7. (C) Power worried that the government ignored two looming problems: the decade-long run-up in public sector pay and the possibility that the government may need to inject funds into the ailing Irish banking system. On the latter, he is skeptical of the government's official line that they do not foresee a need to "re-capitalize" the banking system. Power thinks such a move is "a real possibility." On public sector pay, he believes the government just postponed the inevitable by not making a serious effort at cutting government staff levels. This will need to be addressed next year or the year after, he predicted. Power lamented the fact that the government had not controlled spending over the last seven years. If it had, he said, then they would now be able to pursue an expansionary fiscal policy (more spending), which would help lift the economy out of recession.

The "Social Partners" View

¶8. (C) Business and labor representatives note that the government will have to walk a fine line in order to put its fiscal house in order but not tip the economy further into recession. Danny McCoy, Director of Policy at the Irish Business and Employers Confederation, said that the budget situation is "not as bad as it seems" but that the trick for government is how best to "ride the wave" back to the top of the economic cycle. He said that as the Irish economy stalls the government's fiscal stance should be expansionary (more spending). However, this is not possible given the already large budget deficit. John Sweeney, economic advisor to the trade union ICTU, added that members in his union were most concerned about the tax increases (VAT and the income levy) for those "who can least afford them."

The Viewpoint Outside Dublin

¶9. (C) At the local and county level, senior officials are preparing for a round of belt-tightening. Although generally enthusiastic about the economic prospects for his county, Conn Murray, Louth County Manager, said that less spending at the national level will adversely affect Louth. In particular, he foresees potentially cutbacks in "soft" infrastructure like community centers and social programs for poorer segments of society. Michael Walsh, Waterford City Manager, repeated these concerns and added that cutbacks in capital infrastructure projects will do the most damage in

his constituency. Unlike Louth which is situated between Dublin and Belfast, Waterford is in a part of Ireland that has "probably benefited the least from the strong economic growth" over the past two decades. New roads are needed to provide better connections with Dublin and, he hopes, renewed prospects for growth.

Comment

¶10. (C) This was indeed a tough budget. The criticism from the political opposition is predictable. After all, Fine Gael has been trying to pin the blame for "losing the economy" on Prime Minister (and former Finance Minister) Brian Cowen since the Irish economy began unraveling. What is telling, though, is the almost unanimous disappointment from other people we spoke to and from commentators in the media. Some jokingly -- we hope -- asked us how they could get U.S green cards. The main complaint is that the government focused far too heavily on the revenue side at a time when the Irish economy can ill-afford a slowdown in private-sector consumption. To be fair, the government is not in a position to stimulate the economy. However, some

here worry that not only is the government shying away from making hard choices on public sector reform but that it underappreciates the woes facing the Irish banking system. If the government has to inject capital into the financial system to save the banks, then the numbers announced yesterday will need to be recast. In addition, Ireland's economic plight has added another distraction (on top of the failed Lisbon Treaty referendum) for the government to deal with, which may result in less focus on issues that matter to the U.S.
FAUCHER